# — STATEMENT OF DETERMINATION AND ORDER —

*OF THE*

*SECRETARY OF FOOD AND AGRICULTURE*

*REGARDING PROPOSED AMENDMENTS*
*TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK*
*THAT ADDRESS THE CLASS 1, 2, 3, 4a and 4b PRICING FORMULAS*

*BASED UPON A PUBLIC HEARING HELD ON JANUARY 12, 2001*

Signed in the Office of the Secretary
Wednesday, February 21, 2001

## SUMMARY OF DETERMINATIONS

A duly noticed public hearing was held by the Department of Food and Agriculture (Department) on January 12, 2001, to consider adjustments to the pricing formulas used to calculate minimum farm prices for Class 1, 2, 3, 4a and 4b milk. At that hearing, testimony and evidence were introduced into the record regarding proposed adjustments to all minimum classified pricing formulas. Additional testimony was collected through submissions of briefs following the close of the hearing.

In weighing the testimony and evidence on the hearing record, the Department has determined that the current Stabilization and Marketing Plans for Market Milk continue to effectuate the declared purposes of the Food and Agricultural Code.

## Report Background and Layout

The determination not to amend the Stabilization and Marketing Plans for Northern California and Southern California (Plans) is based on evidence received into the Department of Food and Agriculture's hearing folder. The folder includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held January 12, 2001 and written post–hearing briefs.

## INTRODUCTION

California Food and Agricultural Code Section 61801, *et sec.*, provides the authority, procedures and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of Milk Stabilization and Marketing Plans for Market Milk (Plans).

The Department held a public hearing on Friday, January 12, 2001 in Sacramento, to consider amendments to the Plans. The Department called the hearing after receiving a petition submitted by the Western United Dairymen. The call of the hearing considered amendments to all five minimum pricing formulas. One alternative proposal, submitted by the Dairy Institute of California, was received by the December 13, 2000 deadline. Two additional proposals were received on December 29, 2000, from the petitioner regarding increased energy costs for dairy producers.

**Summary of Proposals:**

- Western United #1: Permanently floor the Class 1, 2, 3, 4a and 4b prices by using the higher of commercial commodity prices or federal support purchase prices to incorporate the federal dairy support program directly into the California system of minimum pricing.

- Dairy Institute: Permanently reduce the Class 1 price by $0.364 per hundredweight to make processors more competitive.

- Western United #2: Temporarily increase the Class 1, 2 and 3 prices by a variable amount equal to a multiplier times any on-farm increases in utility costs.

- Western United #3: Temporarily increase the Class 1, 2 and 3 prices by $0.25 per hundredweight to cover fuel surcharges.

A total of 21 witnesses testified including the Department's witness. Witnesses appeared on behalf of the following organizations:

1. Candace Gates – CDFA
2. Richard Matteis – CA Grain and Feed Association*[1]
3. Raymond Kelly – Baker Com.& Pacific Coast Renderers Assoc.
4. James Wegner – Safeway/Vons
5. Jay Goold – Western United Dairymen
6. Michael Marsh – Western United Dairymen*
7. William Schiek – Dairy Institute*
8. Kevin McLaughlin – Security Milk Producers*
9. Geoffrey Vanden Heuvel – Milk Producers Council
10. Loren Lopes - AMPSI
11. John Jeter - Hilmar Cheese Company*

[1] *Indicates the witness also filed a post-hearing brief.

12. John Hitchell - Kroger Company
13. Steve James - Swiss Dairy
14. Michael Reinke - Kraft Foods
15. Lynne McBride - California Farmers Union
16. Sue Taylor - Leprino Foods
17. Ed Gassmann - Stremicks Heritage Foods
18. Joe McGowan - Dreyer's Grand Ice Cream
19. Sharon Hale - Crystal Cream & Butter Company*
20. Jim Tillison - Alliance of Western Milk Producers*
21. James Gruebele - Land O' Lakes*

In addition, written submissions were received from two persons not giving oral testimony:

Rich Ghilarducci - Humboldt Creamery Association
Gregory Dryer – Saputo Cheese

A summary of the state of the dairy industry in California and in the U.S. can be found in the background material distributed at the pre–hearing workshop on December 21, 2000 and at the hearing on January 12, 2001. The background document also contains public policy considerations and statutory criteria for establishing and amending Stabilization and Marketing Plans and the Pooling Plan. The background document is incorporated herein by reference.

## REVIEW OF PREVIOUS HEARINGS
## Regarding the Minimum Classified Pricing Formulas

**March 31, 1993**

This hearing was convened to consider alternatives to the Class 1, 2 and 3 pricing formulas. Changes were made to the Class 1 pricing formula. First, for the 14–month period June 1993 through July 1994, the current Class 1 pricing formula was replaced by the formula using only the CRP. Second, the CRP was permanently altered by the inclusion of Grade B (whey) butter price and yield factors. Third, value was shifted from fat (decreased by $0.1428 per pound) to SNF (increased by $0.0230 per pound) and fluid (increased by $0.0023 per pound). No changes were made to the Class 2 and 3 pricing formulas.

**September 30, 1993**

As a result of a hearing held September 30, 1993, to consider alternatives to the current Class 1, 2, and 3 farm pricing formulas, the following changes were made. Two changes were made to the Class 1 pricing formula. First, the current Class 1 farm pricing formulas was permanently replaced by a formula using only the CRP. Second, a base price increase of approximately $0.84 per hundredweight was combined with shift from fat (decreased by $0.1428 per pound) to SNF (increased by $0.0569) and fluid (increased by $0.0096). The Class 2 and 3 differentials were increased $0.01 per pound for fat and $0.02 for SNF for a combined increase of $0.21 per hundredweight.

**April 21, 1995**

As a result of the hearing, a temporary $0.13 per hundredweight increase in the Class 1, 2, 3, 4a and 4b prices was established. The increase was a fixed $0.0107 per pound of both fat and SNF. The temporary increase was operational from June 1995 through January 1996.

**December 5, 1995**

A hearing was held to consider proposed amendments to the Milk Stabilization and Marketing Plans regarding the pricing formulas for Class 4a and 4b milk. As a result of testimony and evidence entered into the hearing record, the Department made the following changes to the pricing formulas: **Class 4a** – Decrease the manufacturing cost allowance for nonfat dry milk from $0.16 to $0.14 per pound; as soon as possible, replace the Chicago Mercantile Exchange (CME) Grade AA butter price and freight adjustment with a weighted average Grade AA butter price for salted butter in 55 and 68 pound blocks, f.o.b. California manufacturing plants; eliminate the use of the federal support purchase price for butter and NFDM in the formula; and, in the event the California weighted average butter price is not available, then the CME Grade AA butter price, less a freight adjustment of $0.45 per pound, shall be used in its place. **Class 4b** – Decrease the manufacturing cost allowance for cheese from $0.195 to $0.018 per pound; as soon as possible, replace the National Cheese Exchange (NCE) 40 pound block Cheddar cheese price with a weighted average 40 pound block

Cheddar cheese (aged 10 to 30 days) price, f.o.b. California manufacturing plants; eliminate use of the federal support purchase price for Cheddar cheese and eliminate use of the "price mover"; eliminate use of the moisture adjuster; in the event that the California weighted average Cheddar cheese price is not available, then the NCE price for 40 pound blocks, plus a marketing adjustment of $0.01 per pound, shall be used.

**August 9, 1996**

This hearing addressed the issue of milk price alignment using surrounding states as references. The Department determined that California Class 1 price was to high relative to other adjoining states and was encouraging importation of out–of–state milk into California. The Class 1 pricing formula was revised by calculating the CRP in a different manner. For the 6–month period October 1996 through March 1997 the CRP was the simple arithmetic mean of the two alternative calculation methods — Cheddar cheese & whey butter or butter & NFDM.

**October 4 & 8, 1996**

Two hearings were held in Fresno and Sacramento to consider consolidating the South Valley and Northern California Marketing Areas. The two areas were consolidated. The Class 1 price for the "new" Northern California Marketing Area (NCMA) will be a weighted average of the Class 1 prices existing in the two previous areas. The new Class 1 component prices are the former NCMA prices except the fluid price was increased by $0.0004 per pound.

**February 5 and 7, 1997**

These two hearings were held to address milk price alignment with other states. The following changes were made to correct the misalignment.

1. Class 1 prices were frozen at the February/March 1997 level for the April/May 1997 pricing period;
2. CRP in the future will be based on Cheddar cheese prices without use of the "higher of;"
3. CRP will be based on a single (current) month;
4. Shift value from SNF back to fat;
5. Reduce the value of the fluid component in the Class 1 price, and
6. Shift value from fat to fluid component in the Southern California Marketing Area.

**April 21, 1997**

The National Cheese Exchange (NCE) was being terminated, and a cheese exchange was being established at the Chicago Mercantile Exchange (CME). The old pricing formulas for both the Class 4b price and the CRP used NCE cheese prices. As a result of this hearing, both formulas now reference CME cheese prices.

**May 8, 1998**

The CME announced that it would no longer trade Grade B butter at the Exchange. A hearing was held to consider the best indicator of the value of whey butter. As a result of the hearing, the CRP formula uses the simple average CME Grade AA butter price less ten cents ($0.10).

**September 21, 1999**

This hearing was called to address Class 1 milk price alignment with other states. To correct the misalignment, the base price in the Class 1 pricing formula was lowered by $0.57 per hundredweight (whole milk) and monthly pricing replaced bimonthly pricing. The allocation of value to milk components was changed such that the Class 1 fat price is priced directly using the CME Grade A butter price with deductions for freight and manufacturing costs, and SNF and the fluid carrier were priced as residuals.

**January 31, 2000**

This hearing was called in response to a petition submitted jointly by the Alliance for Western Milk Producers and Western United Dairymen. The call of the hearing was limited to the Class 1 pricing formula including the CRP. One alternative proposal was submitted by the Dairy Institute of California. As a result of the testimony and evidence received during the hearing process, the Department made the following amendments to the Milk Stabilization and Marketing Plans for Northern and Southern California:

For the calculation of the Class 1 price,

- Use the higher of the CRP based on butter and nonfat dry milk or cheese and whey butter.
- Use CME commodity price data observed from the 26th of the second prior month through the 10th of the prior month for butter and cheese, and the most recent two weekly reports for California NFDM available as of the 10th of the prior month.
- Replace the freight adjustment and manufacturing cost allowance in the Class 1 fat price formula with a fixed adjuster equal to 10 cents per pound.
- Decrease the CRP differential from $0.494 to $0.464 per hundredweight.

## ANALYSIS OF THE HEARING RECORD

Summaries of testimony received at the January 12, 2001 hearing and of the post-hearing briefs are attached to this document. The analyses and determinations made below were made after a careful review of the entire hearing record.

*BACKGROUND*

The following economic data and statistics were considered when examining and evaluating the proposals and testimony submitted at the hearing.

**California Milk Production**

California continues to produce more milk from more cows:

- Annual milk production has increased every year since 1978.
- Milk production has increased at an average rate of 4 percent for the last ten years; nationwide, the figure is slightly less than 1 percent.
- In 1999, milk production increased at double-digit levels because of high milk prices and low feed prices in 1998-99.
- Cow numbers have increased at an average rate of 2.6 percent for the last ten years; nationwide cow numbers have decreased at a rate of 1.1 percent.
- For the twelve months ending September 2000, California cow numbers increased 3.6 percent compared to a 0.7 percent increase nationwide.

**California Cheese Production**

The cheese industry is a major part of the growing California Dairy industry:

- In 2000, 39 percent of California's total milk production was used in making cheese.
- California is ranked second in the nation in cheese production, with an 18 percent share of the market.
- California cheese production has doubled over the last ten years to 1.4 billion pounds.
- Cheese production in California has averaged a growth rate of 8.0 percent over the last ten years and 9.5 percent over the last twelve months. (Over the last ten years, the rest of the US only averaged 2.7 percent.)

**Minimum Price Levels**

- California's recent pool prices, the prices that dairy producers receive, were neither significantly lower nor higher than those of the last ten years. More importantly, California's Class 1, 2, 3 and 4a prices were generally higher compared to previous years.
- However, California's Class 4b prices prior to the hearing were at a low level. They were a direct result of the commercial wholesale price for

cheese and reflected surplus production of cheese (driven in a large part by California's cheese expansion) relative to commercial demand.

**Price Alignment**

- While California's Class 4a and 4b prices may vary on a month-to-month basis, over the longer term, both pricing systems have resulted in similar price levels.
- California's Class 1, 2 & 3 prices are near the levels of federal order prices in neighboring states. For example, in 2000 prices for California and neighboring markets were as follows:

| Market | City | Price per cwt. | Price per gallon |
|---|---|---|---|
| No. California | San Francisco | $13.32 | $1.15 |
| So. California | Los Angeles | $13.59 | $1.17 |
| Pac. Northwest | Portland | $13.45 | $1.16 |
| Az. – Las Vegas | Phoenix | $13.90 | $1.20 |

**Dairy Market Loss Assistance Program**

- In 1998, Congress appropriated $200 million ($5,900 for each producer) for direct payments to U.S. dairy producers (DMLA-I) for the purpose of compensating for low market prices and authorized an additional $125 million ($3, 600 for each producer) in direct payments in 1999 (DMLA-II).
- In December 2000, USDA announced DMLA-III with a projected cost of $667 million with a cap of approximately $25,000 per producer.

In summary, California dairy producers were eligible to collect up to $34,500 since 1999 from the three federal programs.

***As with any analysis using historical data, the past is not necessarily a good predictor of the future. This is particularly true for Western United's utility proposal that involves a variable price increase that is triggered by changes in dairy producers' cost of utilities. Simply, there is no meaningful historical data available from which we can develop a traditional analysis.***

**DAIRY INSTITUTE**
**Reduce Class 1 Prices by $0.364 Per Hundredweight**

## The Proposal

Dairy Institute proposed a permanent reduction to the Class 1 price by $0.364 per hundredweight (cwt.) in an effort to enhance the competitiveness of California processors. They specifically addressed competition Southern California processors have in selling packaged milk into Las Vegas, Nevada. Processors also testified about the competition Northern California processors have with packaged Oregon milk being sold into Northern California.

## Impact of the Proposal

On a hundredweight basis, the Dairy Institute proposal would uniformly lower Class 1 prices throughout the state thereby decreasing producer overbase prices by 8 cents per cwt. (see Table 1). Their proposal would also tend to lower fluid milk prices to consumers by 3.1 cents per gallon on whole milk, 3.5 cents per gallon on reduced fat 2 percent milk, 3.8 cents per gallon for lowfat 1 percent milk and 3.3 cents per gallon for skim milk. (see Table 2 and Figure 4).

Southern California fluid processors currently compete with Arizona processors for in-state sales and sales into Las Vegas, Nevada. Southern California processors currently pay a comparable price for whole fluid milk compared to processors in the Arizona federal order (see Figure 7). The Dairy Institute proposal for a permanent Class 1 decrease would result in Southern California whole milk prices averaging below Arizona prices.

Lowering California Class 1 prices could benefit California consumers if lower farm prices are passed along. Lower California Class 1 prices would also increase in-state processors' competitiveness with out-of-state processors for both in-state and out-of-state sales. If out-of-state Class 1 sales increase, pool revenues to producers could also increase. If revenues from Class 1 sales increase more than the pool revenue decreases from lower farm prices, total pool revenue to producers will be higher. However if sales do not increase more than the price decreases, lower farm revenue may result in less pool revenue.

*Processor Competition for Fluid Milk Sales*

California processors must compete with out-of-state processors for both in-state and out-of-state sales. In California, the State's higher fluid milk standards apply and processors generally choose to produce four types of milk at California's nutritional standards: one each for whole (3.5 percent 8.7 percent), reduced fat (2 percent, 10 percent), lowfat (1 percent, 11 percent) and skim (0.1 percent 9 percent).

Out-of-state processors, choosing to market fluid milk in California, also must meet California's higher nutritional standards for the types of milk sold within the State. Processors competing for sales in surrounding states usually choose to reduce their nutritional standards to federal levels (especially for reduced fat and lowfat milks) to avoid significant fortification costs. California and federal nutritional standards are similar for both whole and nonfat milk. Processors testified that when they process both California standard milk and federal standard milk for the reduced fat and lowfat milk types, their costs increase significantly. Costs for processors that only choose to sell in surrounding states may be lower, especially for the Las Vegas area where minimum mandated farm prices are lower.

Based on testimony from fluid processors, the competitive problem seems to be mainly in the Las Vegas market, with fewer problems in Northern California. However, Northern California processors have more of a price disadvantage relative to Oregon processors than Southern California processors do relative to Arizona processors (see Figure 7). Yet, the Institute proposal would uniformly lower prices in both Northern and Southern California. For example, for the 13 months ending January 2001, the period when the new federal order pricing has been in effect, the Northern California price for whole milk averaged only $0.144 per hundredweight above the federal Class I price f.o.b. Portland, Oregon.

Dairy Institute also referenced Section 62062.1 of the Food and Agricultural Code in its proposal and testimony. Section 62062.1 requires an annual review of California's Class 1 prices for milk at 3.5 percent fat and 8.7 percent solids-not-fat compared to the price for the same milk in neighboring markets. If the Department finds that the weighted-average Class 1 price in California on a calendar-year basis is not in a reasonable relationship to prices in neighboring states, the Department shall call a public hearing to address the matter.

The Department's recent analysis for the calendar year 2000 did not find that California's Class 1 prices for milk at 3.5 percent fat and 8.7 percent solids-not-fat were in an unreasonable relationship to those in neighboring states.

Significant uncertainty faces the U.S. dairy industry between now and June 1, 2001, the date Dairy Institute proposes the Class 1 price decrease should take effect. The severity and duration of the current energy crisis remains to be documented. The period of high production increases has begun to ebb, thereby beginning to strengthen commodity markets. The status of changes to the federal milk marketing order system is in the hands of USDA and the federal courts.

**Determination —** Make no changes to the Class 1 pricing formula at this time.

**WESTERN UNITED PROPOSAL #1:**
**Floor Class 1, 2, 3, 4a and 4b Prices with the Support Purchase Prices.**

## The Proposal

The Western United proposal would impose a permanent floor on Class 1, 2, 3, 4a and 4b prices through the inclusion in the pricing formulas of the higher of commercial commodity prices or federal support purchase prices. Western United wishes to incorporate the federal Dairy Price Support Program (DPSP) directly into the California system of minimum pricing. This will guarantee a floor on California prices tied to the federal target support price.

## Background: *The Federal Dairy Price Support Program*

Under the DPSP the Federal Government (CCC) stands ready to purchase butter, Cheddar cheese and nonfat dry milk (NFDM or powder), at the support price, from any qualified processor in the nation, at any time the processor chooses to do so. The intent of the program is to stabilize the market place during times when supply is in excess of demand; thereby ensuring that processors can pay producers a viable price for their milk.

The law provides that:

> "*PURCHASE PRICES - The support purchase prices under this section for each of the products of milk (butter, cheese, and nonfat dry milk) announced by the Secretary shall be the same for all of that product sold by persons offering to sell the product to the Secretary. The purchase prices shall be sufficient to enable plants of average efficiency **to pay producers, on average, a price that is not less than the rate of price support** for milk in effect.*" Subsection (c), Section 141 (Milk Price Support Program), Chapter 1 (Dairy), Subtitle D (Other Commodities), 1996 Farm Bill.

## Impact of the Proposal

The actual impact of this proposal will depend on market conditions. If commercial butter, Cheddar cheese and NFDM prices are all above their support purchase prices, then this proposal will have no impact on any of the class prices. If commercial butter or NFDM prices are below their support purchase prices, then Class 2, 3 and 4a prices will be higher under this proposal and Class 1 price may be higher. If the commercial Cheddar cheese price is below its support purchase price, then Class 4b prices will be higher.

It must be recognized that the federal order pricing formulas do not reflect the federal support price in the calculation of the federal order prices. Any upward adjustment of California's pricing formulas to reflect the support price will make California dairy products less competitive. There was testimony that California's relative size and importance in the manufactured market will influence commodity prices in the commercial market and thereby indirectly influence federal order prices, the efficiency and magnitude really is uncertain.

No one can predict what the long-term future market conditions for the Cheddar cheese, butter and powder markets will be. We must, therefore, rely on a review of market conditions and prices from 2000 (known with certainty) to make realistic projections for the balance of 2001. Again, past market behavior is not necessarily a good predictor of what any future market behavior will be.

On a hundredweight basis, Table 1 shows that in 2000 most of the impact of Western United's proposal would fall on Class 4b (cheese) plants. In 2000, Western United's proposal would have tended to increase consumer prices slightly (see Table 2). The proposal will place California cheese processors at a competitive disadvantage relative to cheese processors in federal orders (see Figure 12). If both commercial butter and NFDM prices fall below their respective SPP, then consumers may be impacted by Western United's proposal. However, under current market conditions, for the rest of 2001 California consumers should not see any price increases for butter because of this proposal.

Given current market conditions, for the rest of 2001 Western United's proposal will probably only affect the Class 4b price significantly. In the long run, it could affect all class prices.

Although there were large month-to-month variations in 2000, on an annual average basis California butter-powder and cheese processors were competitive with out-of-state processors (see Figures 9 and 10). Western United's SPP floor proposal would have had little impact on butter-powder processors; however, it would have raised competitive problems for California cheese processors. Because of the mechanics of the pricing formulas, the effect of the proposal is equivalent to reducing the manufacturing cost allowance for all cheese processors by as much as 7.8¢ per pound.

In the long run, California fluid milk, yogurt, cottage cheese, ice cream, butter, powder and cheese processors may be less competitive with out-of-state processors. Out-of-state processors generally pay prices established by the federal milk marketing orders (federal orders). These prices are not floored by the support purchase price. November 2000 represents the most lopsided month to date, with commercial market prices being far below the established support price. Under Western United's proposal, the California price for cheese milk would have been $0.91 per hundredweight higher than in federal orders.

In the future when commercial commodity prices are below support purchase prices, the proposal will increase producer income from all classes of milk provided processors are able to move product.

In the long run, the proposal may transfer money from producer members of butter-powder processing cooperatives to all other producers. For the rest of 2001, it is likely to cause a transfer of money from producer members of cheese processing cooperatives to all other producers. Also, it will transfer money from producers receiving premiums from cheese plants to all other producers.

There have been times in the last ten years when each of the commercial prices has been below their SPP. The commercial butter price has not been below support since 1995. At the time of the hearing, the commercial price for NFDM was barely above its support purchase price and had been below it for the first nine months of 2000. For all of 2000, NFDM was as much as $0.0030 per pound below its SPP, averaging $0.0014 below.

Commercial Cheddar cheese prices had not been below the support purchase price (SPP) since May 1991. Since 1999, the commercial price averaged $0.23 per pound above the support purchase price; it peaked at $0.78 per pound above in 1998. The year 1991 was last time the federal government purchased any significant quantity of Cheddar cheese.

In the fall of 2000, the cheese market fell significantly below the SPP, (as much as 12 cents per pound lower). For most of the period beginning in September of 2000, the CME price for Cheddar cheese has been below the support price. Consequently, commercial Cheddar cheese prices were below its SPP at the time of the hearing.

The DPSP was to be phased out at the end of 2000. Most cheese and butter processors sought commercial outlets to end reliance on government sales. (Processors of NFDM looked to commercial export markets. However, without subsidies these markets were closed. The NFDM support purchase price was above the market-clearing price because it had been set artificially high relative to the butter SPP.) Record milk prices and low feed costs in 1998-99 contributed to increased milk production. Increased milk production was used in making cheese. Because of the excess supply, the commercial Cheddar cheese price fell below support. The system for grading and inspection for governmental cheese purchases had not been in use for about ten years. Witnesses testified that both Cheddar cheese processors and federal governmental agencies were not ready to handle the sudden need for government purchases of Cheddar cheese.

California Class 1 prices have never been floored by any SPP. However before 1995, Class 2, 3 and 4a prices were floored by SPPs for butter and nonfat dry milk. The concept of having a price floor was eliminated from the formulas because the DPSP was scheduled to terminate. Since then, the DPSP has been extended on an annual basis and may or may not be extended in the next farm bill.

In January 2000, federal order reform introduced an end product pricing system to replace the old federal milk pricing system. However, under the new end-product pricing system, the federal order pricing formulas rely on market prices for butter, nonfat dry milk and Cheddar cheese similar to California, and therefore have fallen below the support purchase price recently. While California has included a support price floor in some of its formulas prior to 1995, the competitive environment generated by federal order reform makes such a floor imposed solely on California processors problematic.

California Class 4b prices have never been floored by the support purchase price for Cheddar cheese. The reason for this is that Cheddar cheese can be sold at the support purchase price to the federal government. However, 70 percent of California's cheese is not Cheddar. Processors making cheese other than Cheddar, cannot sell their product to the federal government as an alternative market. When the market price for commercial Cheddar cheese goes below support, the price other cheese makers receive also declines. This is the reason given in past hearing findings for not flooring the Class 4b prices by the SPP for Cheddar cheese.

Some cooperative representatives supported Western United's proposal. Many cooperatives process butter/powder but relatively small quantities of cheese. Over the past year, the powder price has been close to the SPP, and the butter price has been far above the SPP. Thus, for the rest of 2001, there is less potential that Western United's proposal would have much impact on the Class 4a minimum price.

Dairy issues involve a great deal of judgement. Because of California's comparative advantage in milk production, an essential problem is marketing increasing quantities of milk on the commercial market. The attraction and maintenance of manufacturing plants is a critical factor in the future development of the California dairy industry. Unlike milk deficit states, the California dairy industry's long-term success is not based solely on its ability to attract added milk production.

The downside risk of incorporating the SPP proposal is far too great a cost when compared to the potential added revenues dairy farmers may receive. In the worse case, if the national cheese supply exceeds commercial demand, some processors may curtail or cease production in California. Classes 4a and 4b are critical to clear the supply of farm milk. If prices are set too high, farm milk will either be dumped, shipped long distances to find a home or producers will be driven to find ways to circumvent minimum farm prices. This balancing role is described in Section 62062 of the Food and Agricultural Code.

As referenced above, the intent of the DPSP is for processors to be able to pay producers the designated support price. With one very brief exception in 1992, the California overbase price has been above the $9.90 support price since 1988.

Producer representatives argued that for the last twelve months, the overbase price paid to producers was below the Department's Cost of Production Index. The Cost of Production Index is an index and is not an absolute cost. The Index is designed to measure changes in costs, not absolute cost levels.

The current formulas appear to be working adequately.

**Determination** —The proposal to introduce the SPP into the Class 1, 4a and 4b formulas is not adopted.

## WESTERN UNITED PROPOSAL #2:
## Increase Class 1, 2 and 3 Prices Based on Increases in Utility Costs

### The Proposal

Western United proposed that the Class 1, 2 and 3 prices be increased temporarily based on increases in on-farm utility costs. They said dairy farmers needed higher prices to offset the increased cost of power that farmers are facing. The proposal specifically assigns the price increase to Classes 1, 2 and 3 (28 percent milk utilization) and does not extend the adjustments to the pricing formulas for Classes 4a and 4b (72 percent milk utilization).

The mechanics of the proposal require a monthly comparison of dairy farm utility costs, as determined by the Department, with a baseline established using 1999 annual data. In the case where the baseline cost is exceeded, the difference is trebled and then distributed to the component prices (e.g., fat and solids-not-fat) for Classes 1, 2 and 3. The proposal specifies a 24-month duration from the date of implementation.

### Impact of Proposal

The nature of this proposal does not lend itself to a straightforward analysis. The key is that the proposal compares the current utility costs to a historic baseline as the initial step to adjusting the pricing formulas. The extent to which utility costs may increase in the future is not at all clear, especially in light of California's current energy crisis. As a result, the determination regarding this proposal is based on a hypothetical "if-then" analysis in which utility costs increase incrementally.

Utilities represent about 2.0 percent of the total cost of producing milk for the most recent ten months of data available. For the ten months of January through October 2000, the on-farm cost of production data shows a statewide cost of utilities at $0.23 per hundredweight of milk produced. Current data (January 2000 – October 2000) shows that utility costs are actually lower than the 1999 annual data used for the baseline. However, it is recognized that some of the largest cost increases occurred more recently and have yet to be reflected in cost studies.

Table 1 shows that the impact of Western United's proposal on monthly prices for 10 percent and 30 percent increases. At the 10 percent level, producers would realize a $0.06 per hundredweight increase for Classes 1, 2 and 3; at the 30 percent level, producers would realize a $0.20 per hundredweight increase for Classes 1, 2 and 3. Because Classes 1, 2 and 3 represent about 28 percent of all the milk produced in California, the increase in the quota and overbase prices would be considerably lower. For a 10 percent increase in utility costs, pool prices would increase by $0.02 per hundredweight, and for a 30 percent increase in utility costs pool prices would increase by $0.05 per hundredweight.

Table 4 also shows how the impact of the proposal will vary depending on the level of increase in utility costs. A 2 percent increase in utility cost increases the prices for Classes 1, 2 and 3 less than $0.01 per hundredweight. A 40 percent increase would result in a $0.26 per hundredweight increase, indicating that because utilities represent only a fraction of total milk production costs, a very large increase in the cost of utilities is required to effect a significant increase in milk prices.

In theory, the proposal could increase consumer prices under the presumption that price increases for Classes 1, 2 and 3 would be passed through to consumers by processors and retailers (see Table 2). Because of their relatively high percentage of dairy-based ingredients, the largest impacts would be on fluid milk products and premium ice cream.

California processors compete against processors in nearby federal orders for sales, whether they occur within or outside of California. Western United's proposal for an increase based on utility costs can only increase minimum prices; there is no provision in the proposed amendment that would allow farm prices to be adjusted downward if the cost of utilities were to decrease. Therefore, it is clear that the proposed amendment can only negatively affect the competitive environment facing California Class 1, 2 and 3 processors if competitors' costs do not rise commensurately.

The presence of national dairy processing firms in California adds complexities to the issue of comparable Class 1 price levels among neighboring milk markets. Representatives from the Kroger Co. and Suiza Foods indicated that they have the flexibility to supply markets outside California from plants located in Arizona or Nevada. They further indicated that decisions to shift production from one plant to another are examined regularly, and minimum price is a major consideration in these decisions. With minimum prices for milk in Southern California and in Arizona tracking very closely, any increase in the Southern California price would provide an additional incentive for companies to shift production from California to other states (see Figure 7).

The Department has similar concerns for plants processing Class 2 and 3 products. The panel recognizes that milk utilization data over the past five years do not indicate that California has lost Class 2 and 3 production. For example, since 1995, utilization of Class 2 milk on a total solids basis has increased by 24 percent, and utilization of Class 3 milk on a total solids basis has increased by 27 percent. While it is clear that California's processing capacity for Class 2 and 3 products has increased, it has not kept pace with the amount consumed in California and has lost market share (see Figure 10). Furthermore, we remain concerned that there is a potential for processors to relocate facilities from California to other states if minimum class prices are not reasonably close to comparable prices in other states.

The Department recognizes the relative softness of dairy commodity markets and the associated impact that those markets have on California minimum prices. Further, it acknowledges the potential impact on producers resulting from higher energy costs. However, relative to costs, the quota and overbase prices received in 2000 are below the levels in 1998 and 1999, but comparable to those received in the remainder of the 1990s.

There are several problems with the proposal. Department staff was unable to verify actual cost increases and submit them as part of the hearing record. It appears that the largest cost increases did not occur until December 2000 and later. The data collected by the Department was only able to verify costs realized through October 2000. Witnesses at the hearing were also unable to document actual utility cost increases.

The proposal is a mechanism to offset anticipated energy cost increases. Therefore, the Department must speculate about the magnitude, frequency and duration of cost increases if the impact of the proposal is to be assessed. Whereas this may be possible, it is noted that there are no precedents to grant a price increase to offset anticipated cost increases. Unless the circumstances are extraordinary, the Department prefers to analyze the merits of price increases after such increases in costs have occurred and can be verified.

The energy crisis is a statewide problem that affects producers, processors, retailers, affiliated businesses and consumers. Granting price increases to producers based on increased energy costs favors one side of the industry. It is inconsistent to isolate and provide relief for dairy producers' increased energy costs without also considering similar relief for dairy processors by adjusting manufacturing cost allowances.

The specificity of the proposal also causes some concern. The proposal singles out a line item from the data collected by the Department's Cost of Production Unit and makes price adjustments based on the line item's relationship with a baseline figure. Granting the proposal sets a precedent of adjusting prices based strictly on specific milk production cost items, which starts to introduce the idea of allowing the cost of production to set milk prices. If the proposal were accepted, it would then be logical to propose a similar amendment for other costs that increase by more than the baseline. This is inconsistent with the concept of using the prices of end products as the best measure of all economic factors related to supply and demand. The petitioner stated that it did not support a return to the old formula that included a factor for changes in the cost of production.

Finally, the proposal does not address the issue of increased energy costs directly. The mechanics of the proposal are such that increases in other cost items that are included in the utility category (e.g., water, sewer and telephone) could trigger a price increase without the cost of energy increasing at all. There is nothing in the hearing record that documents that increases in utility costs will cause more than normal and expected fluctuations in the total cost of production.

**Determination** – The proposal to increase the Class 1, 2 and 3 prices based on increases in the utility component of on-farm production costs above a baseline is not adopted.

## WESTERN UNITED PROPOSAL #3:
## Increase Class 1, 2 and 3 Prices by $0.25 Per Hundredweight

### The Proposal

Western United proposed a temporary increase of $0.25 per hundredweight applied to the prices for Classes 1, 2 and 3 to offset fuel surcharges experienced by dairy farmers. They stated that these fuel surcharges were instituted to cover increased costs for delivery of feed, transportation of milk to processing plants, and removal of animals from dairies.

The mechanics of the proposal are straightforward and involve applying a $0.25 per hundredweight increase to the prices for Classes 1, 2 and 3. The increases are divided among the relevant milk components with approximately 40 percent of the increase applied to fat and approximately 60 percent of the increase applied to the nonfat portions of milk. The proposed amendment has a 24-month duration.

### Impact of Proposal

Table 1 shows the impact of the Western United's proposal on monthly prices for Class 1, 2 and 3. The proposed increase does not apply to Class 4a and 4b. Because Class 1, 2 and 3 represent about 28 percent of all the milk produced in California, the net increase in the quota and overbase prices would be considerably lower at $0.07 per hundredweight.

In theory, the proposal would increase consumer prices under the debatable presumption that price increases for Class 1, 2 and 3 can be and will be passed through to consumers by processors and retailers (see Table 2). Because of their relatively high percentage of dairy-based ingredients, the largest impacts would be on fluid milk products and premium ice cream.

California processors compete against processors in nearby federal orders for sales, whether they occur within or outside of California. Western United's proposal for a $0.25 per hundredweight increase strictly increases prices paid by California processors. There is no provision in the amendment that would allow farm prices to be adjusted downward if fuel surcharges were to decrease or be suspended. While intended to provide relief for dairy producers, it seems clear that the proposed amendment would, at the same time, negatively impact the competitive environment facing California Class 1, 2 and 3 processors.

The presence of national dairy processing firms in California further complicates the issue of comparable Class 1 price levels among neighboring milk markets. Representatives from the Kroger Co. and Suiza Foods indicated that they have the flexibility to supply markets outside California from plants located in Arizona or Nevada. They further indicated that decisions to shift production from one plant to another are examined regularly, and minimum price is a primary consideration in these decisions. With the minimum prices for milk in Southern California and in Arizona tracking very closely, any increase in the Southern California price would provide an incentive for companies to shift production from California to other states (see Figure 7).

The Department has similar concerns for plants processing Class 2 and 3 products. The panel recognizes that milk utilization data over the past five years do not indicate that California has lost Class 2 and 3 production. For example, since 1995, utilization of Class 2 milk on a total solids basis has increased by 24 percent, and utilization of Class 3 milk on a total solids basis has increased by 27 percent. While it is clear that California's processing capacity for Class 2 and 3 products has increased, it has not kept pace with the amount consumed in California and has lost market share (see Figure 10). Furthermore, we remain concerned that there is a potential for processors to relocate from facilities in California to other states if minimum class prices are not reasonably close to comparable prices in other states.

The Department recognizes the relative softness of dairy commodity markets and the associated impact that those markets have on California minimum farm prices. The panel further acknowledges that fuel surcharges for delivered feed, animal removal and milk transportation are a relatively new phenomenon associated with higher costs for diesel. However, relative to costs, the quota and overbase prices received in 2000 are below the levels in 1998 and 1999, but comparable to those received in the remainder of the 1990s.

Notwithstanding the proposal's potential benefits to producers, it is noted that the proposal has several difficult and unresolved issues. Departmental staff was unable to verify actual cost increases resulting from fuel surcharges and submit them as part of the hearing record. This may be in part the consequence of the date of the hearing, relative to the availability of producer invoices. As of the deadline for data submission into the hearing record, Departmental staff was unable to collect any invoices documenting fuel surcharges. Four documented cases of fuel surcharges were submitted by one organization, Security Milk Producers, as part of their post-hearing brief. However, Departmental staff was not able to ascertain if the surcharges were more widespread than the few cases submitted. No other documented cases of fuel surcharges were submitted into the hearing record by any other hearing participant. Furthermore, the petitioners failed to support the level of increase requested with any relevant data and described the $0.25 per hundredweight increase sought after as an arbitrary number during oral testimony.

While there is concern about increased fuel costs, the Department must adopt a broader view of the problem brought forth by the petitioner. Increased costs for fuel is a statewide problem that affects producers, processors, retailers, adjunct supply businesses, and consumers. Granting price increases to producers for fuel surcharges only looks at one side of the industry. We feel it is inconsistent to isolate and provide relief for dairy producers' fuel surcharges without also considering similar relief for dairy processors by adjusting their manufacturing cost allowances.

**Determination -** The proposal to increase the Class 1, 2 and 3 prices by $0.25 per hundredweight based on fuel surcharges is not adopted.

## SUMMARY OF DETERMINATIONS

As a result of the testimony and evidence received during the hearing process, the Department will continue the current Milk Stabilization and Marketing Plans for Northern and Southern California without amendments.

## FINDINGS OF THE DEPARTMENT OF FOOD AND AGRICULTURE

The Department of Food and Agriculture makes the following findings based upon the testimony and evidence presented at the public hearing held on January 12, 2001 in Sacramento, California and in subsequent post-hearing briefs submitted within the period of time provided by the hearing officer at the above hearing.

The Department has considered all testimony and items of evidence submitted by all parties to these proceedings, whether specifically mentioned herein, in rendering these findings. The Department has considered all provisions set forth in Chapter 2, Part 3, Division 21 of the Food and Agricultural Code, whether specifically mentioned herein, in rendering these findings. These include, without exception, all provisions and declarations regarding public interest considerations.

It is hereby found and concluded that:

(1) The current Stabilization and Marketing Plans for Market Milk now in effect continue to be in conformity with the standards prescribed in and do tend to effectuate the purposes of said Chapter 2.

***Original signed by:***

________________________________________

Tad Bell, Deputy Secretary
California Department of Food and Agriculture

Signed and entered in
the Office of the Secretary
of Food and Agriculture at
Sacramento, California,
On February 21, 2001